

# **DEFENDING THE STATE: A SKEPTICAL LOOK AT "REGULATORY REFORM" IN THE EIGHTIES\***

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In the Eighties those of us who believe that the state should correct the failures of the private market and redistribute income have taken a beating. At the political level we have had to confront a decade of Republican control of the Presidency. The counterweight imposed by the judiciary has steadily eroded as these same presidents have appointed conservative judges. A whole generation of liberal, policy-oriented scholars who came to maturity in the sixties has seen its hopes for a life of public service undermined by changes in the political landscape.

Life has not been much more comfortable in the law schools. There we have been hemmed in by conservative scholars using the lessons of public choice theory to undercut arguments for public intervention and by Critical Legal Studies scholars who argue that since everything is politics, reasoned argument is pointless. Although their attacks are rooted in vastly different ideologies, these critics converge in viewing a progressive, reformist agenda as naive, wishful thinking. Both the right and the left stereotype economics, which has been at the heart of progressive reform for a hundred years, as a conservative, *laissez faire* movement.

But progressives should not retreat into self-pity. Some hopeful signs suggest both that policymakers are beginning to recognize the force of progressive arguments and that legal scholarship and education are moving toward a richer interdisciplinary synthesis.

What is the progressive tradition? Though I will doubtless get the details wrong, butcher history, and offend some who want to keep the label for themselves, I do have something particular in mind. Progressives acknowledge that irrationality, smallmindedness, and greed coexist with rationality, generosity, and frugality, but they are not paternalists. Leaving to one side the education of children, they

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\* Presented as the Thirty-Fourth Annual John R. Cohen Lecture, delivered February 8, 1990, at the University of Colorado School of Law, Boulder, Colorado.

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take people as they find them and deemphasize programs designed either to change values or to prohibit private behavior which imposes no direct cost on others. They favor systems which promote individual choice such as private markets and democratic political processes. The progressives' preferred policy tools emphasize the creation of incentives through imposing costs or providing subsidies.

In substantive policy areas progressives recognize that the existing distribution of property rights is highly contingent and lacks a strong normative justification. Thus they approach the question of the just distribution of income without giving strong normative weight to the status quo. Progressives recognize the overarching importance of scarcity and acknowledge the strength of the market in permitting the decentralized choices of individuals to produce a diverse range of goods and services responsive to individual demands. However, they are sensitive to the multiple sources of market failure from external effects, to monopoly power, to information imperfections, to frictions and lags in the operation of markets. Market failures create a presumption in favor of policy intervention, but one which can be overcome by showing that a public program would be costly and ineffective.

The simple sorting of people into the Right and the Left is too glib to capture the complexity of the progressive position. Republicans are not the enemy. Our reaction to the Reagan record in regulatory affairs is one of disappointment. But you cannot be too disappointed with someone in whom you never had any hope. Some of the fundamental positions of the past administration suggested that genuine reform might occur. Unfortunately, most have proved to be little more than simplistic slogans.

At the level of broad substantive principle there was agreement between the Reagan administration and Progressivism on the need for regulatory reform. Both believed that government intervention in the economy should be justified by reference to market failures and that, insofar as possible, cost-benefit tests should be used to set regulatory policy. At the implementation stage there was also a convergence between progressives and Reaganite rhetoric in favor of market schemes.

This convergence led to the disappointment. Strangely enough, in spite of its strong language, the Reagan administration did not actually do very much. A list of deregulatory accomplishments in the 1989 Report of the Council of Economic Advisors can find little to report after 1984 and many of the earlier initiatives were begun before Reagan took office. Equally surprising, the administration shied away

from genuine, broad-scale incentive-based reforms in the regulation of health and safety.

I attempt a progressive critique of the Reagan administration's governmental reform efforts. The administration claimed that it sought deregulation, decentralization, and privatization. Each word in this triad stands for a valuable aspect of public sector reform. As interpreted by the last administration, however, each one was frequently reduced to an ideological label.

## I. DEREGULATION

Some policymakers in the Reagan administration came perilously close to the position that regulation was per se undesirable. This produced some peculiar blind spots in their regulatory reform proposals. I will discuss three of them. I begin first with the failure to observe that the deregulation of one set of industry practices might increase the need to regulate other aspects of behavior. Second, I consider the Administration's failure to reform social regulation by introducing incentive schemes and conclude with the business world's critique of the Reagan administration's regulatory efforts.<sup>1</sup>

### A. *The Regulation of Deregulated Markets*

The major deregulatory successes of recent years occurred in industries that do not share the natural monopoly characteristics of traditional public utilities. The phasing out of price, entry, and quality regulation in industries ranging from airlines to stock brokerage to telecommunications has markedly increased competition in the deregulated industries.<sup>2</sup> Although most of these deregulatory efforts were begun before Reagan took office and involved the active support of Congress, Reagan officials did support these efforts and made marginal contributions to their implementation.<sup>3</sup>

The deregulation of what have been called "structurally competitive industries"<sup>4</sup> was, however, accompanied by a failure of vision. To an economist the problems are not the ones the popular press emphasizes. Policy failure should not be assumed just because some airlines and banks have gone out of business and some cities are served by fewer air carriers and financial institutions than before deregulation.<sup>5</sup>

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1. Some of the material in this section is drawn from Rose-Ackerman, *Deregulation and Reregulation: Rhetoric and Reality*, 6 J. L. & POL. 287 (1990).

2. For a summary see A. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* xviii-xxiii (1988).

3. 1988 ECONOMIC REPORT OF THE PRESIDENT 198-214 (1989).

4. A. KAHN, *supra* note 2, at xviii.

5. A. Kahn writes that deregulation led to entry that

One must distinguish the inevitable costs of life in a competitive market, where firms are permitted to fail in the interest of maintaining efficiency,<sup>6</sup> from genuine market imperfections that may become more important when firms are given more freedom of action. The response to such issues should not, however, be a return to the regulatory patterns of the past but rather a careful attempt to isolate the remaining sources of market failure and regulate them effectively.

Deregulation of one area of the economy may itself produce the need for more regulation someplace else. In moving toward a more competitive situation in one dimension, bottlenecks and market imperfections in other dimensions may become newly relevant. The Reagan administration poorly incorporated this lesson into recent deregulatory efforts.

For example, airline deregulation with its accompanying increase in flights and congestion on some routes has placed additional strains on the system regulating airline safety and on the allocation of space in airports.<sup>7</sup> In both safety and airport management there are strong economic arguments for a public sector role, and these arguments are stronger the *more* deregulation of routes and fares increases air travel.<sup>8</sup> The Federal Aviation Administration requires more resources for inspectors and air traffic controllers, and the construction of airport capacity is a public works issue of central importance, not just to the citizens of the city involved, but also to those affected by flights in and out.<sup>9</sup>

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produced marked declines in market concentration; it also set off price wars, business failures and consolidations, and labor unrest, along with other rapid changes in accustomed ways of doing business . . . .

[T]he fact that competitive markets—and especially markets suddenly opened to competition after decades of close regulation—tend to be more turbulent than regulated ones is in itself neither surprising nor dispositive of the comparative merits of the two institutions.

*Id.* at xviii. See also Breyer, *Reforming Regulation*, 59 TUL. L. REV. 4, 15 (1984) (disputing that "the fault lies primarily in deregulation" for the bankruptcy of Braniff Airlines and the financial troubles at Continental and Eastern airlines); Rehn, *Charter Curbs Seen Hurting Competition*, AM. BANKER, Apr. 11, 1989, at 2 (discussing the views of the Comptroller of the Currency, Robert Clarke, that new banks must be permitted to enter the market for the sake of efficiency).

6. See Breyer, *supra* note 5, at 15 ("[t]he simple fact is that a competitive world leaves firms to sink or swim on the basis of their service, prices, and efficiency"); see also Cutler, Book Review, *Regulatory Mismatch and Its Cure*, 96 HARV. L. REV. 545, 549 n.12 (1982) (reviewing S. BREYER, *REGULATION AND ITS REFORM* (1982)) (agreeing with Breyer's view that isolated failures should not defeat deregulation).

7. Breyer, *Antitrust, Deregulation, and the Newly Liberated Marketplace*, 75 CALIF. L. REV. 1005, 1015-16 (1987) (asserting that business travelers must realize that airports are more crowded because prices are lower and airlines are more efficient).

8. See Steiner, *The Legalization of American Society: Economic Regulation*, 81 MICH. L. REV. 1285, 1304 (1983) ("[t]he successful deregulation of airline rates does not lead to a sense that we should leave to the free market the question of whether DC-10 engines are attached in a proper way").

9. As Kahn notes:

Furthermore, deregulation of price and entry may require more diligent government efforts to enforce the antitrust laws and to protect consumers from misrepresentation and "violations of implicit contracts."<sup>10</sup> Both types of government intervention may be required to deal with examples of monopoly pricing on thin routes and complaints of "lost baggage, misleading scheduling, last minute cancellations of flights with few bookings, involuntary bumping of passengers on overbooked flights, and severe delays."<sup>11</sup> Unfortunately, the Reagan administration essentially ignored these problems and focused instead on simply defending airline deregulation against its critics.<sup>12</sup>

As a second example, consider the deregulation of financial institutions which has permitted much diversification by banks and other financial service companies.<sup>13</sup> In the banking and savings and loans industries no changes in the deposit insurance system accompanied the loosening of constraints on loan portfolios. Thus, while bank and savings and loan managers have always had an incentive to finance risky loans because of the lack of monitoring by protected depositors,<sup>14</sup> the opportunities actually to finance risky ventures were limited before deregulation.<sup>15</sup> With more and riskier possibilities available after deregulation, the need for public monitoring increased. However, at least in the savings and loan industry, the opposite appears to have occurred. In keeping with the deregulatory spirit of the times, Reagan appoin-

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[T]he upsurge of traffic need not have entailed the great increase in congestion that we have actually experienced. Responsibility properly rests, instead, with major failures of government policy—inadequate staffing of the Federal Aviation Administration with safety inspectors and flight controllers; failure to expand airport and air corridor capacity sufficiently; inefficient pricing of airport takeoff and landing "slots" at congested airports.

A. KAHN, *supra* note 2, at xxii.

10. *Id.* at xxii n.14.

11. *Id.*

12. See *Airline Deregulation: Maintaining the Momentum*, in 1988 ECONOMIC REPORT OF THE PRESIDENT 199-229 (1989). This section does, however, discuss ways to relieve congestion through pricing landing slots.

13. See, e.g., Depository Institutions Deregulation and Financial Simplification Act, 12 U.S.C. §§ 3501-3524 (1980); Garn-St. Germain Depository Institutions Act, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C. (1982)). See generally Comment, *Requiem on the Glass-Steagall Act: Tracing the Evolution and Current Status of Bank Involvement in Brokerage Activities*, 63 TUL. L. REV. 157 (1988); Note, *Ownership of Member Banks by Mutual Fund Advisers under the Glass-Steagall Act*, 52 FORDHAM L. REV. 691 (1984).

14. For recent discussions of this issue see R. LITAN, WHAT SHOULD BANKS DO? 109-11 (1987); Lovett, *Moral Hazard, Bank Supervision and Risk-Based Capital Requirements*, 49 OHIO ST. L.J. 1365 (1989); Macey, *The Political Science of Regulating Bank Risk*, 49 OHIO ST. L.J. 1277 (1989).

15. See, e.g., Bennett, *A Banking Puzzle: Mixing Freedom and Protection*, N.Y. Times, Feb. 19, 1989, § 3, at 13, col. 2. ("with the deregulation craze in full swing, . . . banks are going ahead willy-nilly . . . to enter new, and sometimes riskier, activities").

tees failed to obtain budgets and personnel to keep pace with the growth in industry assets.<sup>16</sup>

By the end of the Reagan administration even the economists on the President's Council of Economic Advisors recognized the importance of this problem. Their last report included a section which called for reform of banking regulation and oversight in response to previous deregulation efforts. They supported reform of the deposit insurance system and a redefinition of "the appropriate sphere of competition for depository institutions."<sup>17</sup>

In short, deregulation in one area often requires new regulation and oversight someplace else. The Reagan administration's failure to see this point until the very end of its tenure indicates that it espoused a rigid ideology in which symbol was elevated above the substance of insuring a more efficiently operating economy.

### *B. Incentive-Based Systems*

Not only did the Reagan administration fail to do much to advance the cause of economic deregulation, it also failed to reform the system of social regulation. The administration introduced no systematic reforms in the areas of environmental law and health and safety regulation.

Too often liberals view the use of incentive schemes, which use prices or subsidies as part of a regulatory plan, as deregulatory and therefore suspect.<sup>18</sup> Thus one might have hoped in 1981 that an administration insulated from the appeal of such rhetoric might have moved in a balanced way to introduce incentive-based elements into the regulation of environmental and product quality.<sup>19</sup> Yet this did

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16. Barth & Bradley, *Thrift Deregulation and Federal Deposit Insurance*, 46-47 (Paper presented at the conference on Perspectives on Banking Regulation, Federal Reserve Bank of Cleveland, Nov. 1988) Barth & Bradley criticize the federal insurers for failing to respond appropriately to the deregulation of deposit institutions:

A private insurer implements immediate changes when faced with an important structural event. First, it collects data to determine if the actuarial basis for its pricing system needs to be changed; then if it remains profitable, it offers insurance. Second, it examines the behavior of those insured to determine if insurance should be limited or denied. Third, the insured are segmented by risk characteristics, with the deductible and premium established for each segment.

The federal deposit insurers took none of these actions when faced with the deregulation of the institutions whose deposits they insured. In fact, in some important ways, the federal insurers took actions directly opposite to those that would have been taken by a private insurer. By not instituting practices more similar to those of private insurers, the guarantee aspect of federal deposit insurance became more important.

17. *Airline Deregulation: Maintaining the Momentum*, in 1988 ECONOMIC REPORT OF THE PRESIDENT 204 (1989).

18. See, e.g., S. KELMAN, *WHAT PRICE INCENTIVES?* (1981).

19. B. EADS & J. FIX, *RELIEF OR REFORM? REAGAN'S REGULATORY DILEMMA* (1984) [herein-

not happen in more than a very limited way. Some limited attempts at reform were made at the Environmental Protection Agency<sup>20</sup> and the Federal Communications Commission,<sup>21</sup> but the mood was deregulatory not reformist. One explanation for this failure may be that, while the incentive systems which economists and policy analysts favor rely on market-like constructs, they at the same time require regulated firms to pay for the damage they do. Therefore, the very firms which praise the virtues of the market in other contexts may oppose these reform proposals.

Such schemes, if properly designed do not represent deregulation at all, but rather regulatory redesign which can permit the more cost-effective achievement of statutory goals. In areas such as pollution of the air and the water, market tests and efficiency imply regulation, not deregulation. The use of financial incentives may mean that higher levels of cleanup are possible than with command and control regulation. Such schemes could produce genuine reform, not a sellout to the regulated firms. Efficient regulation implies a concern for both costs and benefits; it does not imply less regulation.<sup>22</sup>

The Bush administration, whose proposed amendments to the Clean Air Act recommend a pollution rights scheme to control sulfur dioxide emissions, appears to be moving in a progressive direction. However, its sulfur dioxide proposal, a variant of which is in the bills passed by each house of Congress, is marred by the fact that existing dischargers will be given rights equal to current discharges. Thus firms will obtain a property right in their pollution which can be sold to others. Although this allocation device should, in principle, have no impact on the ultimate distribution of pollution loads—high-cost polluters will buy rights from low-cost polluters, it provides a windfall

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after RELIEF OR REFORM?]. "[E]conomists hoped that Reagan would embrace the concept as the principal vehicle for the regulatory relief he was pledging." *Id.* at 104.

20. Hahn & Hester, *Where Did All the Markets Go? An Analysis of EPA's Emissions Trading Program*, 6 YALE J. ON REG. 109 (1989).

21. RELIEF OR REFORM?, *supra* note 19, at 171-172.

22. An early statement of this view is found in C. SCHULTZE, *THE PUBLIC USE OF THE PRIVATE INTEREST* (1977). See also L. LAVE, *THE STRATEGY OF SOCIAL REGULATION* (1981); *Law and Economics Symposium: New Directions in Environmental Policy*, 13 COLUM. J. ENVTL. L. 153, 153-356 (1988). In their symposium article, Ackerman and Stewart summarize the studies of the savings that would be generated by the introduction of incentive schemes to control air pollution.

Of the twelve studies of different air pollutants . . . seven indicated that traditional forms of regulation were more than four times more expensive than least-cost solutions; four indicated that they were about seventy-five percent more expensive; and only one suggested a modest cost-overrun of seven percent . . . . Even if a reformed system could cut costs by "only" one-third, it could save more than \$15 billion a year from the nation's annual expenditure of \$50 billion on air and water pollution control.

Ackerman & Stewart, *Reforming Environmental Law: The Democratic Case for Market Incentives*, 13 COLUM. J. ENVTL. L. 171, 176-77 (1988).

to existing dischargers that cannot be justified on distributive grounds. Since such an allocation plan has the obvious advantage of dampening the opposition of dischargers, it presents a clear conflict between equity and political expediency.

Other proposals have been made to pay workers to accept personal protective devices, to charge firms an "injury tax," to sell rights to the microwave spectrum, to tax gasoline on the basis of its pollution content, to auction landing slots at congested airports, and to permit auctions for the right to such natural monopolies as cable television franchises. Economists have developed schemes to determine the level of public goods through demand-revealing mechanisms and have applied them in some limited contexts such as the choice of television programs for public television stations. Some of these ideas are not operational at present while others have been used in limited contexts. Nevertheless, political support of incentive schemes seems to be higher than ever before, and proposals that were made by economists twenty or even thirty years ago are suddenly being viewed as dramatic new developments. Though we should avoid jumping uncritically on the bandwagon, I believe that a sober evaluation of many of these proposals would show that many of them are promising and can be made operational. The Reagan administration has at least performed the function of placing these ideas on the agenda. In a world of tight budgets and opposition to general tax increases, such fee schemes have undoubted appeal.

### *C. Deregulation and the Business Community*

The final failure of the Reagan administration is filled with irony. The administration sometimes failed even in its perception of what was best for the business community. Accepting the inevitability of regulation and wanting some clarity and certainty in their environment, business leaders sometimes pressed recalcitrant agencies to promulgate regulations.

A federal government that has hobbled itself by cutbacks in regulatory budgets and personnel<sup>23</sup> is unable to respond expeditiously to

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23. See R. HARRIS & S. MILKIS, *THE POLITICS OF REGULATORY CHANGE* 124-25 (1989) which reports that from FY 1981 to FY 1985 the Federal Trade Commission lost 11% of their funding and over one-third of their permanent staff positions. The Consumer Product Safety Commission lost 16% of its funding and over forty percent of its positions. The budget of the Environmental Protection Agency fell from \$1.347 million to \$1.039 million between 1981 and 1983 and full-time employees fell by 1500. The research and development budget was cut in half. *Id.* at 255-56. The overall budget of the federal regulatory agencies, after falling in real terms in the early years of the Reagan administration, rose slowly in real dollars after 1983. 1988 ECONOMIC REPORT OF THE PRESIDENT 194-95 (1989).



business calls for clarity and uniformity in regulations. Furthermore, if an agency, when it does act, is so lacking in qualified personnel that its product is sloppy and poorly justified, it will face court challenges that will further delay the promulgation of rules and take resources away from other efforts. It seems simply a mistake to suppose that business wants regulatory agencies to run poorly. They might wish the laws off the books or at least amended, but given their reality, I would suppose that firms, in general, favor competent administration.<sup>24</sup>

Business may, of course, benefit from efforts by regulatory agencies to repeal or revise existing rules. However, if an agency acts in a rushed and careless manner, its efforts may not be upheld by the courts. The most important example of this was the attempt early in the Reagan administration to repeal the passive restraint standard for automobiles without a careful analysis of alternatives. The Supreme Court turned back this effort with even the most conservative members of the Court supporting the basic requirement that obviously relevant options be considered.<sup>25</sup> Countering this decision, however, were two other Supreme Court cases giving agencies discretion to overrule a previous administration's interpretation of a statute and upholding an agency's power to determine its own enforcement agenda.<sup>26</sup> Nevertheless, the lesson of these cases, taken together, seems to be that regulatory reform efforts within agencies can only succeed if officials articulate a principled justification based on an understanding of the

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24. See generally R. HARRIS, & S. MILKIS, *supra* note 23; D. VOGEL, *FLUCTUATING FORTUNES: THE POLITICAL POWER OF BUSINESS IN AMERICA* (1989). Vogel quotes a Washington attorney for the Chemical Manufacturers Association as stating, "The chemical industry certainly doesn't want to see the EPA dismembered," and quotes a business lobbyist as saying, "We're in favor of intelligent implementation of the laws, but an agency in disarray can't do that." *Id.* at 266-67. Harris and Milkis document business criticisms of the EPA under Anne Burford:

As far as the NAM [National Association of Manufacturers] was concerned, the lack of any clear intellectual framework for deregulation or sense of mission at the EPA cast Reagan, Watt, and Burford as despoilers of the environment catering to the whims of businesses at the expense of public health and environmental quality. This displeased business interests as much if not more than it displeased the Sierra Club.

R. HARRIS, & S. MILKIS, *supra* note 23, at 262.

25. *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983). For other examples involving the EPA see R. HARRIS & S. MILKIS, *supra* note 23, at 263-64.

26. *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984); *Heckler v. Chaney*, 470 U.S. 821 (1985).

facts.<sup>27</sup> Simple inattention can reduce the pages in the Federal Register,<sup>28</sup> but genuine reform requires expertise and commitment.

## II. DECENTRALIZATION

The Reagan administration also expressed a rhetorical commitment to a reconstitution of the federal system with more authority given to state governments.<sup>29</sup> Its rhetoric, however, has not been followed by efforts to repeal laws that preempt or supplement state initiatives.<sup>30</sup> Instead, it has implemented the "new" federalism by cutting funds and freezing budgets in health, housing and other social welfare areas, and by increasing the pace of formal delegation and relaxing federal oversight of state implementation of environmental and health and safety laws. Viewing decentralization as a pro-business strategy is deeply problematic as the Reagan administration has found to its dismay. Decentralization can produce confusion and interstate competition that has few of the desirable normative properties of free market competition.

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27. "An agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance." *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 42. In a recent article Judge Wald argues that judicial review can

dull somewhat the meat axe, "damn the torpedoes, full speed ahead," attitude that sometimes overtakes zealous political appointees advancing a political or ideological agenda . . . [I]ts value may be greater . . . in times when the Executive is embarked on radical change. It is in such times that the temptation to cut corners, to mow down the intransigent opposition is greatest.

Wald, *The Realpolitik of Judicial Review in a Deregulation Era*, 5 J. POL'Y ANALYSIS & MGMT. 543 (1986).

28. The Reagan administration made much of the reduction in Federal Register pages during its tenure. Total pages peaked at 87,012 in 1980 and reached a low of 47,418 in 1986. Total pages rose to 49,654 in 1987. Final rule documents fell from 7,745 in 1980 to 4,581 in 1987. However, while in 1982 5% were eliminations of existing requirements, by 1987 only 2% fell in that category. The percent representing revisions rose from 24% to 27%. The Federal Communications Commission, an agency in the forefront of the deregulation movement, increased the number of final rules from 393 to 444 between 1982 and 1987. Sometimes one must regulate to deregulate. In contrast, large declines were tabulated for the Department of the Interior and the Environmental Protection Agency. OFFICE OF MANAGEMENT & BUDGET, REGULATORY PROGRAM 1988-1989, app. IV, at 558-59.

29. Reagan declared in his first inaugural address that "[i]t is my intention to curb the size and influence of the federal establishment and to demand recognition of the distinction between the powers granted to the federal government, those reserved to the states or to the people." Inaugural Address by President Ronald Reagan, Washington D.C. (Jan. 20, 1981) quoted in Beam, *New Federalism, Old Realities: The Reagan Administration and Intergovernmental Reform*, in THE REAGAN PRESIDENCY AND THE GOVERNING OF AMERICA 414, 418-19 (L. Salamon & M. Lund, eds. 1985).

30. Beam, *supra* note 29, at 415; Champion, *Comments: The Big Impacts Were Indirect* in THE REAGAN PRESIDENCY AND THE GOVERNING OF AMERICA 443, 444-47 (L. Salamon & M. Lund, eds. 1985). As Champion writes: "The President's initiative was not stillborn, but it never left the incubator." *Id.* at 444.

### A. State Statutes

In a federal system, when the central government is inactive, state and local governments may step in to fill the gaps. This can produce a hodgepodge of different rules that are costly for national firms selling and producing in many markets. Such regulations may be explicitly designed to favor locally-based firms over others.

Frank Easterbrook and Ralph Winter have argued that interstate competition for business will produce a "race to the top" that will encourage a search for innovative public sector programs. The state with the best set of laws will win the competitive struggle. The conditions for this result are, however, very restrictive. There must be no interstate externalities and no prisoners dilemma. The laws used to attract firms must not have an impact on anyone else in the state, managers must be good agents for stockholders, and state politicians must be good agents for voters. If any of these conditions is absent, the argument that interstate competition produces efficient regulation is unpersuasive. For example, Winter himself argues against permitting states to determine rules governing mergers and takeovers because he fears that managers may not be good agents for shareholder interests.

Therefore, in areas without absolute federal preemption, firms may sometimes prefer an active federal agency which establishes uniform rules.<sup>31</sup> One business critic claimed that the new federalism resulted in a "state regulatory nightmare," a "50-headed hydra."<sup>32</sup>

In other situations, where firm managers favor a decentralized approach, ordinary citizens may oppose it for fear that interstate competition will make them worse off. In spite of its states' rights rhetoric, the Reagan administration did respond in a limited way to these concerns by proposing preemptive federal rules in the areas of trucking, hazardous waste transport, and the generation of nuclear waste.<sup>33</sup> But in most areas they did little to further a decentralized approach beyond some fiery rhetoric which produced a Congressional backlash,<sup>34</sup> and a generally hands off attitude which left lower-level governments unsure about what the federal policy was.

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31. D. VOGEL, *supra* note 24, at 266; Mashaw & Rose-Ackerman, *Federalism and Regulation*, in *RELIEF OR REFORM?*, *supra* note 19, at 127-36, 153-79.

32. *State Regulators Rush in Where Washington No Longer Treads*, BUSINESS WEEK, Sept. 19, 1983, at 124, *quoted in* Beam, *supra* note 29, at 439. Beam illustrates this point with an example from the Occupational Health and Safety Administration (OSHA). In November 1983 OSHA issued rules requiring firms to inform their employees of workplace hazards. The rules were supported by industry but opposed by labor because they would preempt state laws, some of which were tougher than the OSHA standards. Beam, *supra* note 29, at 439.

33. Mashaw & Rose-Ackerman, *supra* note 31, at 112.

34. Beam, *supra* note 29, at 439-40.

### B. State Tort Law

Some supporters of the Reagan presidency were almost as committed to the common law as they were to the private market. Yet here too their faith has been tested. Shifts in products liability law and medical malpractice have made tort law into something close to an insurance system for those harmed by risky products and practices and in the process has increased the implicit regulatory role of the courts.<sup>35</sup> It is not obvious that this is what defenders of the common law had in mind in praising the common law courts. This trend toward decentralized, nonstatutory lawmaking pushed the Reagan administration into proposing legislation that would preempt these state court initiatives,<sup>36</sup> a strange reversal for an Administration supposedly committed to deregulation and decentralization.

### III. PRIVATIZATION

Calls for privatization of governmental activities during the last administration suffered from the same kind of rhetorical overkill as calls for deregulation and decentralization. Much of value was submerged in overblown claims for the benefits of private economic activity.

Part of the problem is ambiguity about what privatization involves. At its strongest it means eliminating a government presence, either as spender or regulator, and leaving the activity entirely to private actors.<sup>37</sup> For programs with no idiosyncratic capital this would involve simply cancelling the program. When the government owns specialized capital, it would be sold either piecemeal or as a going concern. Thus a privatizer might recommend the sale of the Tennessee Valley Authority,<sup>38</sup> or more controversially, the national forests and parks and the United States Postal Service.<sup>39</sup> The sale of Conrail was

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35. See R. LITAN & C. WINSTON, *LIABILITY: PERSPECTIVES AND POLICY* (1988).

36. In April 1986, the Reagan administration sent three bills to the Senate proposing a \$100,000 cap on punitive damage and pain and suffering awards. None of the bills were voted on by the full Senate. *Administration Proposes Changes in Liability Law*, 44 CONG. Q. WEEKLY REP., 1002 (1986).

37. Savas calls this "load shedding." E. SAVAS, *HOW TO SHRINK GOVERNMENT: PRIVATIZING THE PUBLIC SECTOR* 118-24 (1982).

38. Even the Reagan administration was not brave enough to propose selling the TVA, but in its budget for fiscal year 1987 it did propose the sale of five regional power administrations. Kent, *Privatization of Public Functions: Promises and Problems*, in *ENTREPRENEURSHIP AND THE PRIVATIZING OF GOVERNMENT* 3, 6 (C. Kent ed. 1987).

39. The United States Privatization Commission issued a report in March 1988 which recommended that the possibility of private ownership of the USPS be considered, with priority being given to employee ownership. *Airline Deregulation: Maintaining the Momentum*, in 1988 ECONOMIC REPORT OF THE PRESIDENT 213-14 (1989). The administration's proposed budget for fiscal year 1987 suggested the sale of government assets worth \$8.5 billion or 1% of the government's anticipated revenues for

a prime example of such a privatization strategy<sup>40</sup> as was the sale of national corporations in Great Britain under the Thatcher government.<sup>41</sup> Thus under this interpretation the debate is not about the form of the public program but about proper governmental functions.

I wish to put to one side this meaning of privatization. Though a commitment to reduce taxes and spending was a major aim of the Reagan administration, one should not conflate it with the question of the role of private firms in the administration of existing programs. Therefore, here I focus on privatization as a plan for using private firms to provide public services either directly through contracts or indirectly through issuing vouchers to beneficiaries.

Under Reagan the move to private contractors went quite far. The White House revised and simplified OMB Circular A-76 intended to require contracting out in cases where it would save money.<sup>42</sup> While some committed privatizers have criticized the Circular's limited impact,<sup>43</sup> it does seem to have had some effect.<sup>44</sup> For example, at the Environmental Protection Agency the budget for contractors increased by 300% in the Eighties.<sup>45</sup> In the National Aeronautics and Space Administration contract employees account for more than half of NASA's workers.<sup>46</sup> The Department of Housing and Urban Development gave wide discretion to private lenders.<sup>47</sup>

Already these actions have generated criticism. The use of private contractors at NASA has led to claims, not of cost savings and efficiency, but of cost overruns and false certification of parts.<sup>48</sup> Part of the problem is alleged to be a corresponding fall in the agency's

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that year. The list included the sale of power administrations, airports, public housing, loans, petroleum reserves and railroads. Kent, *supra* note 38, at 6-8.

40. *Airline Deregulation: Maintaining the Momentum*, in 1988 ECONOMIC REPORT OF THE PRESIDENT 212 (1989).

41. D. SWANN, *THE RETREAT OF THE STATE: DEREGULATION AND PRIVATIZATION IN THE UK AND US* 189-292 (1988).

42. Invitation for Public Comment, Proposed Revision to OMB Circular No. A-76 "Performance of Commercial Activities", 48 Fed. Reg. 1,376 (1983); Issuance of OMB Circular No. A-76(Revised) "Performance of Commercial Activities", 48 Fed. Reg. 37,110 (1983).

43. Poole & Fixer, *Privatization of Public-Sector Services in Practice: Experience and Potential*, 6 J. POL'Y ANALYSIS & MGMT. 612, 622-23 (1987).

44. See Commercial Activities Inventories, 53 Fed. Reg. 46,004 (1988), which is a response to Exec. Order No. 12615, 3 C.F.R. § 259 (1987), reprinted in 31 U.S.C. § 501 note (1988).

45. *Regulators Say 80's Budget Cuts May Cost U.S. Billions in 1990's*, N.Y. Times, Dec. 19, 1989, at A1, col. 5.

46. *NASA's Reliance on Contractors Is Seen as Eroding Its Capabilities*, N.Y. Times, Sept. 28, 1989, at A1, col. 4.

47. *Loss of \$4 Billion Is Found in Audit of Mortgage Fund*, N.Y. Times, Sept. 28, 1989, at A1, col. 6.

48. *NASA's Reliance on Contractors Is Seen as Eroding Its Capabilities*, N.Y. Times, Sept. 28, 1989, at A1, col. 4.

technical and monitoring capabilities. Some observers of HUD claim that lenders vastly overvalued property that was being mortgaged, leading to losses for the government.<sup>49</sup> Similar problems have arisen in other federal loan programs.<sup>50</sup>

Reagan officials seem to have jumbled together the goal of deregulating the private sector and privatizing the provision of government goods and services. Just because it is efficient to deregulate the airlines and the trucking industry, it does not follow that the state should relax the monitoring of its own contractors. It is surely not a sign of high quality private sector management to hire a contractor to carry out a customized project and then to let him simply submit bills with little oversight. Firms "get on the back" of contractors if they have no confidence in an arms length relationship. In fact, firms are likely to engage in vertical integration or joint ventures in many areas where government agencies sign contracts. A more "businesslike" government does not necessarily mean one that uses more outside contractors and monitors them less.

The growing revelations of fraud and abuse involving private contractors have dampened the enthusiasm of all but the most devoted privatizers. But we should not let current scandals overwhelm analysis. As the scandals make obvious, contracting out reduces the ability of the government to monitor program administration.<sup>51</sup> Therefore, to be supported, it must have other corresponding benefits. What are these potential benefits? I can think of five.<sup>52</sup>

- (1) The use of private firms can be a way to avoid government restrictions that hamper effective program administration (e.g. civil-service requirements, purchasing restrictions) and to lessen political pressures on administrators.
- (2) Competitive pressures for productive efficiency and high-quality performance can substitute for direct regulation of service delivery.
- (3) Program beneficiaries may be given a greater degree of choice.
- (4) Private providers may offer a greater variety of services and

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49. *Loss of \$4 Billion Is Found in Audit of Mortgage Fund*, N.Y. Times, Sept. 28, 1989, at A1, col 6.

50. *Regulators Say 80's Budget Cuts May Cost U.S. Billions in 1990's*, N.Y. Times, Dec. 19, 1989, at A1, col 6.

51. Thayer, *Privatization: Carnage, Chaos, and Corruption*, in PRIVATE MEANS AND PUBLIC ENDS: PRIVATE BUSINESS IN SOCIAL SERVICE DELIVERY 146-70 (1987).

52. Comment, 6 J. POL'Y ANALYSIS & MGMT., 604-07 (1987) (authored by Susan Rose-Ackerman).

represent greater ideological diversity than public providers, and private firms may be more likely to innovate.

- (5) Public funds may stimulate private giving if they take the form of matching grants to private nonprofit organizations with access to private donations.

The first potential benefit, though probably quite important in practice, is simply an expedient end run around legal constraints. If that is all there is to privatization, the more straightforward response would be reform of the laws governing public bureaucracies.<sup>53</sup> Furthermore, the use of nongovernmental organizations to insulate a program from politics is likely to be unsuccessful as the organizations themselves band together to maintain the public programs which benefit them.<sup>54</sup> One need only look at the political activity of defense contractors to see that this is a realistic concern.<sup>55</sup>

The second possibility raises the question of whether one should equate privatization with the benefits of competitive markets. Clearly, there is no easy analogy. When the government deals with a nominally private but monopolistic supplier, it is not obtaining any of the benefits of competition. Competition, however, can aid efficient service provision in several ways. Even when only a single provider can efficiently serve the public, the government can let potential suppliers compete for the right to provide the best combination of price and service quality. Thus scholars have recommended that rights to cable television franchises, or rights to supply electricity or water, be auctioned off.<sup>56</sup> In some states private firms have bid to provide prison services.<sup>57</sup> However, a competition for the right to supply a service cannot be the end of direct public involvement. The agency must monitor the winning organization to be sure it lives up to its commit-

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53. Sometimes private firms in order to overcome opposition to privatization simply rehire former civil servants to do their old jobs. See, e.g., Kent, *Privatization of Public Functions: Promises and Problems* in ENTREPRENEURSHIP AND THE PRIVATIZING OF GOVERNMENT 18 (C. Kent ed. 1987); C. RING, CONTRACTING FOR THE OPERATION OF PRIVATE PRISONS 43 (1987); Geis, *The Privatization of Prisons: Panacea or Placebo?* in PRIVATE MEANS—PUBLIC ENDS: PRIVATE BUSINESS IN SOCIAL SERVICE DELIVERY 88. (B. Carroll ed. 1987).

54. Geis, *supra* note 53, at 78, argues that privatization of prisons might have the advantage of increasing the political clout of corrections.

55. The political activities of defense contractors are well known. For a discussion of PACS see P. VOGEL, *supra* note 24.

56. See Posner, *The Appropriate Scope of Regulation in the Cable Television Industry*, 3 BELL J. ECON. 211 (1972); see also Zupan, *The Efficiency of Franchise Bidding Schemes in the Case of Cable Television: Some Systematic Evidence*, 32 J.L. & ECON. 401 (1989). But see Williamson, *Franchise Bidding - In General and With Respect to CATV*, 7 BELL J. ECON. 73 (1976).

57. See, "Dungeons for Dollars": *Private Enterprise Sees Money in Jails*, LEGAL TIMES, Nov. 27, 1989, at 28-29; C. RING, CONTRACTING FOR THE OPERATION OF PRIVATE PRISONS (1987). Geis, *supra* note 53, at 89, provides a list of privately contracted penal facilities as of 1985.

ments.<sup>58</sup> If the opportunities for cheating or renegotiation *ex post* are substantial, the benefits of competition between private firms may be very limited compared with direct public provision.<sup>59</sup> Thus some students of government contracting have argued that sealed bidding procedures facilitate collusion and have few countervailing benefits since government agencies routinely approve claims for cost overruns. They argue that efficiency would be improved by underemphasizing competitive bidding.<sup>60</sup>

In contrast, when many private firms can simultaneously provide the service, ongoing competitive pressures can help assure high-quality, low-cost service for clients. In addition, the third benefit of greater choice for clients may be realized. Here is where vouchers or so-called "proxy shopping" plans can be useful.<sup>61</sup> In practice, however, few pure voucher plans exist and not much was done to increase their scope in the Reagan years. The purest example is the food-stamp program, which imposes only minor restrictions on food eligible for purchase and depends upon the working of the overall market for food and the general regulation of agricultural products. In contrast, housing-voucher programs used by HUD limit the program to housing satisfying certain quality constraints, and Medicare and Medicaid both regulate providers.<sup>62</sup>

Fourth, multiple suppliers are needed in order to encourage diversity and innovation. Here one must be careful not to oversell the benefits of privatization. Private for-profit firms are not *per se* innovative and diverse. All we know for sure is that they seek to make money. Thus they must be rewarded for innovation and diversity in order to produce them.

One proposal which may satisfy these conditions was included in a national space policy announced in February of 1988. The idea is to issue "space transportation vouchers" that would permit the research missions queued up for the space shuttle to purchase alternative commercial U.S. launch services. The hope is that such a program will

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58. Kent, *supra* note 53, at 19; C. RING, *supra* note 53, at 15-21.

59. See, e.g., Williamson, *supra* note 56; "Dungeons for Dollars": Private Enterprise Sees Money in Jails, *LEGAL TIMES*, Nov. 27, 1989, at 28-29.

60. For example, see the discussion of U.S. Army contracting in Korea in R. KILTGAARD, *CONTROLLING CORRUPTION* 134-35 (1989).

61. Proxy shopping is a method of service delivery under which those who supply the needy are supported only if they can also attract paying customers. Reimbursement rates are made equal to the prices charged paying customers. For an analysis of the strength and weaknesses of such plans see Rose-Ackerman, *Social Services and the Market*, 83 *COLUM. L. REV.* 1405-12 (1983).

62. *Id.* at 1406-12.



stimulate the entry of private providers of space transportation who will experiment with new methods.<sup>63</sup>

Finally, privatization might be a backhanded way of limiting the substitution of public spending for private charity. Generally, if the government spends more on a service, we would expect that private charitable donations for this purpose will fall. However, if public funds flow to private organizations which also accept private gifts, then it may be possible to stimulate giving instead. The most obvious way to do this is to provide matching grants to charities in the hope that the effective fall in the price of giving will generate additional gifts. The Reagan administration with the help of Congress reduced the incentives for giving by reducing marginal tax rates and cutting back on matching grants to nonprofits. A study of the nonprofit sector showed that charities generally responded to these changed conditions by raising fees, since increases in gifts did not match the fall in public support. The income effect of reduced taxes and the substitution effect of reduced government spending were not strong enough to overcome the price effect.<sup>64</sup>

What then are the basic outlines of the privatization issue? One must look at both the demand and the supply side and analyze the interaction between government-supported output and private demand. Is the service one that private individuals do not purchase, such as a space shuttle, a prison, or an army tank? Then, at most, privatization ought to mean competition among firms for the right to provide the service accompanied by heavy government oversight. Attempts by the last administration to reduce oversight in such situations have predictably led to revelations of shoddy work and even fraud. At the other extreme (food stamps), publicly subsidized clients consume the service (food) alongside paying customers in a market characterized by a large number of providers (super markets and corner groceries). Market pressures regulate price and quality, and the government can limit itself to certifying eligibility and determining the form of the voucher so that beneficiaries have some incentive to patronize efficient, high-quality providers. While the administration talked some about education vouchers and continued earlier efforts in housing, no major initiatives were begun.<sup>65</sup> But there are a multitude of intermediate possibilities that were not explored either. The failure of the Reagan

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63. Macauley, *Launch Vouchers Offer New Space Research Opportunities*, 69 RESOURCES 1 (1989) (newsletter of Resources for the Future).

64. Salamon, *Nonprofit Organizations: The Lost Opportunity*, in THE REAGAN RECORD 261-85 (J. Palmer & I. Sawhill, eds. 1984).

65. Kent, *supra* note 53, at 16-17.

administration was to let sloganeering dominate analysis and rhetoric substitute for genuine reform.

#### IV. CONCLUSIONS

In conclusion I want to be more specific about my own agenda for progressive reform in the areas of economic and social regulation, intergovernmental relations, and the links between the public and the private sectors.

In the economic regulation of prices, entry and service, the "easy" victories have been won. Further progress requires one to understand the remaining arguments for regulation in industries which can support increased levels of competition. The Reagan strategy of picking out a single industry, for example, automobiles,<sup>66</sup> for special treatment under social regulatory programs in order to improve its economic health is unlikely to succeed. The remaining regulated industries are either not primarily regulated by the federal government, (for example, electric power, professionals such as medical doctors and pharmacists), or are under the jurisdiction of independent commissions (for example, communications) and are subject to presidential influence mainly through the appointment of commissioners. Furthermore, natural monopoly arguments apply to many of these industries, at least in part, and sorting out efficient from inefficient regulation will not be a straightforward exercise.<sup>67</sup> My hunch is that, at the federal level, most real progress can be made in the area of social, as opposed to economic, regulation.

In the area of social regulation, where strong economic efficiency arguments for regulation exist and where public support seems strong, reforms should make more use of economic incentives to reduce costs and add flexibility. Such proposals have been prominent features of the analysis of regulatory programs by policy analysts for decades, and several limited applications have been tried. Many of these proposals are close to being operational. The Supreme Court has opened the way for the introduction of incentive-based plans by upholding the constitutionality of user fees promulgated by the Department of Transportation to cover the costs of administering federal pipeline safety standards.<sup>68</sup>

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66. Leone, *Regulatory Relief and the Automobile Industry*, in *RELIEF OR REFORM?*, *supra* note 19, at 87-105; see generally R. CRANDALL, H. GRUENSPECHT, T. KEELER & L. LAVE, *REGULATING THE AUTOMOBILE* (1986).

67. See A. KAHN, *supra* note 2, at xxiii-xxxvii (1988) for a discussion of current issues in public utility regulation.

68. *Skinner v. Mid-America Pipeline Co.*, 109 S. Ct. 1726 (1989). The Department was directed to set these fees by the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272,

Decentralized administration and the transfer of authority to the states is not per se desirable, especially for regulatory programs such as air pollution that have important interstate effects. The states themselves do not want the federal government to abdicate responsibility in these areas since they recognize the potential for destructive interstate competition. Instead, the administration of programs should take account of the geographic extent of problems without either a commitment to devolution or to national uniformity. This would imply the regulation of water pollution at the level of the river basin and of air pollution in a way that takes account of the transport of pollutants. Individual states would not have much of an administrative role. However, when problems are truly local, such as the provision of urban open spaces or the regulation of local aesthetics, individual communities would have primary authority subject, however, to claims that aesthetics or open space zoning are covers for efforts to exclude low income people.

Finally, the role of private contractors, both for-profits and non-profits, needs to be much more clearly defined. The burden should be on anyone proposing privatization to show that competitive pressures will exist and that these pressures will work to the benefit of the government. After all, private firms can compete to pay the highest bribe to the federal procurement officer just as well as they can compete to provide the best product at the lowest price.<sup>69</sup> Giving vouchers to the poor will not help them much if they make their purchases in markets that are either monopolized, or dominated by unscrupulous sellers who misrepresent their products.

Progressive reform of government programs does not reject out of hand the categories of the Republican ideologues. It is, however, critical of the simplistic economic analysis used by these critics of the regulatory-welfare state. Although progressives value individual choice and recognize the efficacy of incentives in affecting behavior, they do not make a fetish of private firms or of unconstrained free market choice. This perspective produces recommendations for regulatory reform, for a reorientation of intergovernmental relations, and for the limited use of private firms and vouchers in implementing public programs. These reforms are not, however, based on a deep distrust of state institutions, but rather envisage an active rule for the state in setting policy and in monitoring the reformed programs. The goal is not to dismantle the state but, to reform it.

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100 Stat. 82 (1986)(codified as amended in scattered sections of 5, 15, 19, 20, 26, 38, and 42 U.S.C. (1988));

69. See, e.g., Thayer, *supra* note 5, at 146-70.

